
Capella University's Compliance with Selected Provisions of the Higher Education Act of 1965 and Corresponding Regulations

FINAL AUDIT REPORT



ED-OIG/A05G0017
March 2008

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U.S. Department of Education
Office of Inspector General

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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

AUDIT SERVICES
Chicago/Kansas City/Dallas Audit Region

March 7, 2008

Mr. Michael Offerman
President
Capella University
225 South 6th Street, 9th Floor
Minneapolis, MN 55402

Dear Mr. Offerman:

Enclosed is our final audit report, Control Number ED-OIG/A05G0017, entitled ***Capella University's Compliance with Selected Provisions of the Higher Education Act of 1965 and Corresponding Regulations***. This report incorporates the comments you provided in response to the draft report. If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Education Department official, who will consider them before taking final Departmental action on this audit:

Lawrence A. Warder
Acting Chief Operating Officer
Federal Student Aid
U. S. Department of Education
Union Center Plaza, Room 112G1
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Washington, D.C. 20202

It is the policy of the U. S. Department of Education to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be appreciated.

In accordance with the Freedom of Information Act (5 U.S.C. § 552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

/s/

Gary D. Whitman
Regional Inspector General
for Audit

Enclosures

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EXECUTIVE SUMMARY

The objectives of our audit were to determine whether Capella University (University) complied with selected provisions of the Higher Education Act of 1965, as amended (HEA), and regulations governing (1) the return of Title IV, HEA program funds; (2) Federal Family Educational Loan (FFEL) and Federal Pell Grant (Pell) disbursements; (3) institutional eligibility; (4) program eligibility; and (5) student eligibility. Our initial audit period covered the period July 1, 2004, through June 30, 2005 (2004-2005 award year). Because we identified instances of non-compliance during the 2004-2005 award year, we expanded our audit for objectives (1) and (2) to include the 2002-2003 and 2003-2004 award years.

The University generally complied with the provisions of the law and regulations governing institutional eligibility, program eligibility, and student eligibility. However, it did not comply with the provisions of the law and regulations governing

1. *The return of Title IV, HEA program funds.* The University did not return all funds disbursed on behalf of students who dropped before the first day of class of the payment period. The University used the midpoint of the academic quarter (payment period) as the withdrawal date for all students who unofficially withdrew, even when the University lacked documentation of the student's attendance during the payment period. As a result, for the 2002-2003 through 2004-2005 award years, the University returned to the Title IV, HEA programs about \$588,000 less than it should have returned. We recommend the Acting Chief Operating Officer (COO) for Federal Student Aid (FSA) require the University to review its files and return the improperly retained Title IV, HEA program funds; revise its policy for returning Title IV, HEA program funds; identify other incorrect calculations for withdrawals after the 2004-2005 award year; and recalculate and return those amounts. We also recommend that the Acting COO for FSA consider fine proceedings against the University under 34 C.F.R. § 668.84.
2. *FFEL and Pell disbursements.* The University disbursed Title IV, HEA program funds (FFEL and Pell) to students who were not enrolled in an eligible program at the time of the disbursement. As a result, the University had the use of about \$3.5 million in federal funds every quarter for 2 to 10 days, and the Department may have made unnecessary interest and special allowance payments related to these funds. We recommend the Acting COO for FSA require the University to develop and implement policies and procedures to provide reasonable assurance that funds are not disbursed to students who are not enrolled.
3. *Exit Counseling.* The University could not provide support to show it conducted exit counseling for 2 of the 25 students in our sample who had ceased at least half-time study at the University. In addition, the University performed exit counseling 11 to 18 months after 3 other students stopped attending. We recommend the Acting COO for FSA require the University to implement its revised policies for exit counseling.

4. *Disbursing funds only to students enrolled in an eligible program.* The University disbursed \$1,891.50 of FFEL Program funds to one student enrolled in an ineligible program. We recommend the Acting COO for FSA require the University to return the \$1,891.50 to the lender; identify any other students who received Title IV, HEA program funds for enrollment in an ineligible program; and return the funds to the Department or lender.

A draft of this report was provided to the University for review and comment on August 23, 2007. We received the University's response, including three separate attachments, on September 25, 2007. In its response, the University partially concurred with Finding No. 1, did not concur with Finding No. 2, and concurred with Findings Nos. 3 and 4. We summarized the University's comments and our responses following each finding. Based on our analysis of the University's comments and additional documentation, we made minor revisions to Finding No. 1, Recommendation 1.1, and Recommendation 3.1.

The entire narrative of the University's comments is included as Enclosure 2. Because of the voluminous nature of and the inclusion of personally identifiable information (that is, information protected under the Privacy Act of 1974, 5 U.S.C. § 552a) in the attachments to the University's comments, we have not included them in Enclosure 2. Copies of the University's attachments, less the personally identifiable information, are available on request.

BACKGROUND

Founded in 1993, the University is a proprietary school headquartered in Minneapolis, Minnesota, and owned by Capella Education Company. According to its web site, the University provides education to more than 14,500 students in 50 states and over 60 foreign countries. It is accredited by the Higher Learning Commission and is a member of the North Central Association of Colleges and Schools. The University provides all of its instruction online and does not have any “brick and mortar” classroom facilities. The University currently offers more than 700 online courses that are part of certificate, undergraduate, and graduate degree programs in more than 80 specialized areas of study. As of January 2006, approximately 83 percent of students were enrolled in graduate or doctoral level programs.

The purpose of the programs authorized by Title IV of the HEA is to provide financial assistance to students attending eligible postsecondary and higher education institutions. The University participates in two Title IV, HEA programs: Pell and FFEL. The Pell Program helps financially needy students meet the cost of their postsecondary education. The FFEL Program enables students or their parents to receive low-cost loans to pay for the costs of attendance at postsecondary education schools.

Approximately 70 percent of the University’s revenue is derived from Title IV, HEA program sources. For the 2002-2003, 2003-2004, and 2004-2005 award years, the University received Title IV, HEA program funding as follows:

| <u>Award Year</u> | <u>Pell</u> | <u>FFEL</u> | <u>Total</u> |
|-------------------|--------------------|----------------------|----------------------|
| 2002-2003 | \$387,531 | \$75,268,410 | \$75,655,941 |
| 2003-2004 | \$650,952 | \$111,865,469 | \$112,516,421 |
| <u>2004-2005</u> | <u>\$1,114,374</u> | <u>\$138,918,174</u> | <u>\$140,032,548</u> |
| Totals | \$2,152,857 | \$326,052,053 | \$328,204,910 |

AUDIT RESULTS

The University generally complied with the provisions of the law and regulations governing institutional eligibility, program eligibility, and student eligibility. However, for the 2002-2003 through 2004-2005 award years, the University did not comply with the provisions of the law and regulations governing the return of Title IV, HEA program funds and FFEL and Pell disbursements. The University did not return all Title IV, HEA program funds disbursed on behalf of students who dropped before their first day of class for the payment period (Finding No. 1); disbursed Title IV, HEA program funds to students who were not enrolled in an eligible program at the time the disbursement was made (Finding No. 2); did not document that it performed exit counseling for all students receiving FFEL Program funds during the 2004-2005 award year (Finding No. 3); and disbursed Title IV, HEA program funds to a student who was enrolled in an ineligible program (Finding No. 4).

For Finding No. 1, the University returned to the Title IV, HEA programs about \$588,000 less than it should have returned. For Finding No. 2, the University had the use of about \$3.5 million in federal funds for 2 to 10 days in every quarter even though it never should have received those funds, and the Department might have incurred additional interest and special allowance costs for those FFEL Program funds.

In response to the draft of this report, the University partially concurred with Finding No. 1, did not concur with Finding No. 2, concurred with Finding No. 3, and concurred with Finding No. 4. The University did not agree with our understanding of the criteria for Finding No. 1, and it did not agree with the definition of “disbursed” we used for Finding No. 2. The University’s response indicated that corrective actions had been taken for Finding No. 1, Finding No. 2, and Finding No. 3, and that it considered Finding No. 4 to be an isolated occurrence. The corrective actions included enhanced procedures for identifying students due refunds, improvements to a pre-disbursement eligibility report, and implementation of a new improved, software system.

After reviewing the University’s comments, we revised Finding No. 1 and Recommendation 1.1, reducing the number of instances of noncompliance described in Finding No. 1 and reducing the recommended amount that should be recovered. We also revised Recommendation 3.1 to reflect the University’s development of revised procedures for exit counseling. We made no other changes to our findings or recommendations.

FINDING NO. 1 – The University Determined Incorrectly the Amounts to Be Returned to the Title IV, HEA Programs

The University did not return all funds disbursed on behalf of students who dropped before their first day of class for the payment period. The University used the midpoint of the academic quarter (payment period) as the withdrawal date for all students who left school without providing official notification to the University (unofficially withdrew). The University used the midpoint even when it lacked documentation that the student engaged in academic activity

during the payment period. By always using the midpoint of the payment period as the student's withdrawal date, the University retained approximately 50 percent of the Title IV, HEA program funds it received on behalf of the students for whom it lacked documentation of academic activity, even though the University was required to return all Title IV, HEA program funds for those students.

According to 34 C.F.R. § 668.21

(a)(1) If a student officially withdraws, drops out, or is expelled before his or her first day of class of a payment period, all funds paid to the student for that payment period for institutional or noninstitutional costs under the Federal Pell Grant, FSEOG [Federal Supplemental Educational Opportunity Grant], and Federal Perkins Loan programs are an overpayment.

(2) The institution shall return that overpayment to the respective title IV, HEA programs in the amount that the student received from each program.

(b) For purposes of this section, the Secretary considers that a student drops out before his or her first day of class of a payment period if the institution is unable to document the student's attendance at any class during the payment period.¹

For FFEL Program loans, pursuant to 34 C.F.R. § 682.604(b)(2)

(i) Except in the case of a late disbursement under paragraph (e) of this section or as provided in paragraph (b)(2)(iii) or (iv) of this section, a school may release the proceeds of any disbursement of a loan only to a student, or a parent in the case of a PLUS loan, if the school determines the student has continuously maintained eligibility in accordance with the provisions of § 682.201 from the beginning of the loan period for which the loan was intended.

.

(iv) If, prior to the transmittal of the proceeds of a disbursement to the student, the student temporarily ceases to be enrolled on at least a half-time basis, the school may transmit the proceeds of that disbursement and any subsequent disbursement to the student if the school subsequently determines and documents in the student's file—

(A) That the student has resumed enrollment on at least a half-time basis;

(B) The student's revised cost of attendance; and

(C) That the student continues to qualify for the entire amount of the loan, notwithstanding any reduction in the student's cost of attendance caused by the student's temporary cessation of enrollment on at least a half-time basis.

¹ All regulations cited are from the July 1, 2004 edition of the Code of Federal Regulations, unless otherwise stated.

Also, in accordance with 34 C.F.R. § 682.604(d)(4)

If the school is unable for any other reason to document that a registered student attended school during the period of enrollment for which the loan is made, the school must . . . return to the lender—

- (i) Any loan proceeds credited directly by the school to the student's account; and
- (ii) The amount of payments made directly by the student to the school, to the extent that they do not exceed the amount of any loan proceeds delivered by the school to the student.

To determine if the University maintained documentation to support student attendance for the payment period and correctly determined the amount it should have returned to the Title IV, HEA programs, we reviewed the records for (1) 166 students randomly selected from a list of 225 students shown as unofficial withdrawals during the 2002-2003 award year, (2) 162 students randomly selected from a list of 221 students shown as unofficial withdrawals during the 2003-2004 award year, and (3) all 319 students shown as unofficial withdrawals during the 2004-2005 award year. The University did not have evidence to support attendance for the payment period and incorrectly determined the amount it should have returned to the Title IV, HEA programs for 69, 88, and 232 of the students, respectively. (See **Table 1**.)

Based on our review, we estimate that the University retained about \$588,000 in Title IV, HEA program funds (\$10,000 Pell and \$578,000 FFEL) for the 389 students who dropped out of school before their first day of class for the payment periods during the 2002-2003, 2003-2004, and 2004-2005 award years.

Table 1

| Award Year | Unofficial Withdrawals (Universe) | Title IV, HEA Universe Amount | Unofficial Withdrawals Tested (Sample) | Title IV, HEA Sample Amount | Instances of Non-compliance | Pell Grant Funds Improperly Retained | FFEL Funds Improperly Retained | Total Title IV, HEA Funds Improperly Retained |
|--|-----------------------------------|-------------------------------|--|-----------------------------|-----------------------------|--------------------------------------|--------------------------------|---|
| 2002-2003 | 225 | \$371,244 | 166 | \$276,951 | 69 | \$0 | \$173,556 | \$173,556* |
| 2003-2004 | 221 | \$231,423 | 162 | \$170,968 | 88 | \$1,579 | \$133,117 | \$134,696** |
| 2004-2005 | 319 | \$351,774 | 319 | \$351,774 | 232 | \$8,662 | \$271,583 | \$280,245 |
| Total | 765 | \$954,441 | 647 | \$799,693 | 389 | \$10,241 | \$578,256 | \$588,497 |
| * We are 90 percent confident that the University retained \$173,556 +/- \$15,249 in Title IV, HEA funds for the 2002-2003 award year. | | | | | | | | |
| **We are 90 percent confident that the University retained \$134,696 +/- \$8,791 in Title IV, HEA funds for the 2003-2004 award year. | | | | | | | | |

The University's procedures for determining the amount of funds to return to the Title IV, HEA programs were not adequate. University officials informed us that, to identify unofficial withdrawals, all faculty members are required to indicate whether a student receiving a failing grade of "F" was given such a grade due to inadequate academic performance or failure to participate in the course. If the faculty member indicates that the student failed to participate, the University determines that the student unofficially withdrew. It is the University's policy to use

the midpoint of the payment period as the withdrawal date when determining the amount of Title IV, HEA program funds to return for all unofficial withdrawals. However, for the students we tested, whom the University identified as unofficial withdrawals, the University's documentation did not show that the students engaged in academic activity during the quarter. Absent evidence of academic activity, the University should be returning all Title IV, HEA program funds for that payment period, not calculating a refund using the midpoint of the payment period as the withdrawal date.

During our audit, the University disagreed with our assertion that its documentation did not support the students' attendance. It stated that the documentation it has for students—for example, a student's agreement to a faculty expectation sheet, introduction to the teacher or other students, or general questions about the homework process—was adequate to document attendance for the purposes of 34 C.F.R. §§ 668.21 and 682.604(d)(4). However, these documents do not indicate any academic engagement. None of the information we reviewed for these students indicated that they attended class or engaged in any academic activity for the purpose of learning its subject.

Recommendations

We recommend the Acting COO for FSA

- 1.1 Require the University to review its files and return the amount of Title IV, HEA funds improperly retained for students who dropped before their first day of class for the 2002-2003, 2003-2004, and 2004-2005 award years. We estimate that the University will need to return \$10,000 to the Department and \$578,000 to lenders.
- 1.2 Require the University to review records for students who unofficially dropped out during the 2005-2006 and 2006-2007 award years; determine which students did not attend during the quarter of the withdrawal; calculate the amount of Title IV, HEA funds the University retained but should have returned to the Title IV, HEA programs; and return those amounts to the Department and lenders, as appropriate.
- 1.3 Require the University to revise its policy for returning Title IV, HEA program funds to provide reasonable assurance that it returns all Title IV, HEA program funds for students who unofficially withdraw with no documentation of attendance for the payment period.
- 1.4 Consider fine proceedings pursuant to 34 C.F.R. § 668.84 because the University failed to return the correct amount of Title IV, HEA program funds for all students who unofficially withdrew.

University Comments

The University partially agreed with the finding and stated that it had implemented and established new procedures to reduce the likelihood of the noncompliance in the future. The University agreed with 203 of 389 instances of noncompliance we found and agreed it improperly retained \$278,883. Based on a review of the Office of Inspector General (OIG)'s audit documentation, the University divided the instances of noncompliance we identified into three categories: (1) instances of noncompliance with which the University agreed; (2) instances for which the University provided additional data, to demonstrate that the University had complied under the criteria presented in our report (though the University disagreed with our understanding of the criteria); and (3) instances with which the University disagreed, based on its

disagreement with our understanding of the criteria. Table 2 below summarizes the University's division of noncompliance into three categories.

Table 2

| Award Year | Students Classified as Type 1 | Title IV, HEA Funds Received | Students Classified as Type 2 | Title IV, HEA Funds Received | Students Classified as Type 3 | Title IV, HEA Funds Received | Total Title IV, HEA Funds Improperly Retained |
|---|-------------------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|------------------------------|---|
| 2002-2003 | 48 | \$89,987 | 1 | \$765 | 21 | \$41,623 | \$89,987 |
| 2003-2004 | 68 | \$78,914 | 3 | \$1,734 | 20 | \$21,837 | \$78,914 |
| 2004-2005 | 87 | \$109,982 | 128 | \$152,710 | 18 | \$18,366 | \$109,982 |
| Total | 203 | \$278,883 | 132 | \$155,209 | 59 | \$81,826 | \$278,883 |
| The University concurs it improperly retained funds for students classified as Type 1, but disagrees that it improperly retained funds for students classified as Type 2 and Type 3. The amounts shown in the column, "Total Title IV, HEA Funds Improperly Retained" are actual funding amounts received by the students in our samples. | | | | | | | |

The University stated it was their understanding, based on prior communications with the OIG audit team, that due to time constraints surrounding the draft report, the audit team was not able to consider and reflect in its draft report all course room activity of all students listed in the work papers. The University also stated that it was their understanding that the audit team intended to consider this additional information following receipt of the University's response to the draft report. As such, the University included comments as to the activities of each student in the course room.

The University stated that our report applies a heightened standard of academic engagement which is not supported by the regulations. Under 34 C.F.R. §§ 668.21 and 682.604(d)(4), a school is only required to demonstrate that a student attended school during the enrollment period; the regulations do not include a requirement to demonstrate academic engagement.

The evidence that the University provided is adequate to show that the students attended school. The University stated

Students attend classes by posting information to virtual course rooms and participating in online class dialogue with faculty and fellow students. Demonstrating attendance in this context, however, is not significantly different from a bricks and mortar setting. When a student posts his or her profile to the course room, poses questions to a faculty member, or agrees to a faculty expectation sheet, the student has attended the class every bit as much as – if not more than – a student who signs into the first day of class at a bricks and mortar institution and otherwise sits silently through one or more lectures.

The University believes that procedural changes it implemented in April 2006, to ensure that students are engaged before funds are delivered, have prevented and will continue to prevent further instances of the non-compliance with which it agreed, as identified in its first category.

OIG Response

Prior to issuing the draft report, we reviewed all available information provided by the University supporting student attendance for this finding. The University spent considerable time trying to extract information from its computer systems that would support student attendance, but was having difficulty obtaining all needed information due to various technical issues. We informed the University that any additional information supporting student attendance could be provided in response to the draft report and would be considered prior to issuance of the final report. The University did provide additional information in response to the draft report that was not available to us prior to the issuance of the draft report.

Based on the additional information provided by the University, we revised Finding No. 1 and Recommendation 1.1 to reflect our acceptance of additional documentation for 5 of the 132 students included in the University’s second category. We also accepted additional documentation to reclassify 4 of the students from the University’s second category to the University’s third category. However, the University did not provide adequate documentation to show that the remaining students in the second category attended during the quarter: the University either provided the same information we reviewed previously, or we were unable to verify the University’s new information using its course room software.

In our finding, we accepted evidence of students’ submitting assignments, discussing the course work and/or assignments, and asking questions specific to the course work and/or assignments as evidence that the online student was academically engaged in course room activity. However, we do not agree that other documentation provided by the University with its comments—documentation for students’ agreements to faculty expectation sheets, introductions to the teachers or other students, or general questions about the homework process—is adequate to show that students in the University’s third category attended class. These activities, which occurred after class started, are more consistent with a student’s registration or orientation than with a student’s attendance. **Table 3** summarizes the information for the students we tested.

Table 3

| Award Year | Students Classified as Type 1 | Title IV, HEA Funds Received | Students Classified as Type 2 | Title IV, HEA Funds Received | Students Classified as Type 3 | Title IV, HEA Funds Received | Total Title IV, HEA Funds Improperly Retained |
|---|-------------------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|------------------------------|---|
| 2002-2003 | 48 | \$89,987 | 0 | \$0 | 21 | \$41,623 | \$131,610 |
| 2003-2004 | 68 | \$78,914 | 0 | \$0 | 20 | \$21,837 | \$100,751 |
| 2004-2005 | 87 | \$109,982 | 123 | \$146,699 | 22 | \$23,565 | \$280,246 |
| Total | 203 | \$278,883 | 123 | \$146,699 | 63 | \$87,025 | \$512,607 |
| Note: The amounts shown in the column, “Total Title IV, HEA Funds Improperly Retained” are actual funding amounts received by the students tested in our samples. The amounts do not include projected amounts for the 2002-2003 and 2003-2004 award years as shown in Table 1. | | | | | | | |

In its comments, the University said, “[T]o satisfy the ‘attendance requirement,’ a bricks and mortar institution would thus only have to demonstrate that a student was present in the classroom.” If a bricks and mortar institution documented a student’s introduction to his or her

teacher, an agreement to faculty expectations, or general questions about the homework process, such documentation would not necessarily be evidence that the student had been present in the classroom. Being present in a classroom requires a greater commitment by a student to participate in the learning process, and this greater commitment should be evident in the documentation of the University's students' attendance.

The University's classes are not conducted within the same structure as traditional classes, and the same assumptions for traditional classes may not apply to online classes. Each class at the University has a start date and an end date, and there may be deadlines for homework or project submissions, but there are typically no specific hours during which the class meets for instruction. Comments and messages may be posted at any time by a student in the University's "online classroom," but without considering the content of those messages, there is no assurance that the student has actually attended the class for the purpose of receiving instruction in its subject.

The University stated that its procedural changes have prevented and will continue to prevent errors resulting in improper retention of Title IV, HEA program funds from and after the date of full implementation in the Summer 2006 quarter. Our testing was performed on students who withdrew prior to the April 2006 implementation of the new modifications. However, the process described by the University calls for the engagement check to be performed after federal funds are received. This means that federal funds would still be requested and received for students who may no longer be attending school. Funds received for students determined to be ineligible would then need to be returned to the Department and/or FFEL lenders. If the University would run the eligibility check before requesting federal funds, it would be able to avoid requesting funds for students who are no longer attending.

FINDING NO. 2 – The University Disbursed Title IV, HEA Program Funds to Students Who Were Not Enrolled

The University disbursed Title IV, HEA program funds (FFEL and Pell) to students who were not enrolled in an eligible program at the time of the disbursement. We reviewed the records² for 205 randomly selected students for whom the University made Title IV, HEA program disbursements during the 2002-2003, 2003-2004, and 2004-2005 award years.³ The University made 27 disbursements of Title IV, HEA program funds to 20 of the 205 students even though the students stopped attending during a previous payment period, were not enrolled in any classes for the applicable payment period, and were not charged tuition for the payment period for which funds were disbursed.

A student is eligible to receive Title IV, HEA program assistance if the student is "a regular student enrolled, or accepted for enrollment, in an eligible program at an eligible institution." (34 C.F.R. § 668.32 (a)(1)(i)) To receive a FFEL or Direct Loan Program loan, the student must attend at least half-time. (34 C.F.R. § 668.32(a)(2))

² Student records reviewed included correspondence, return to Title IV calculations, and billing histories.

³ We reviewed the records for 110 randomly selected students for whom the University made Title IV, HEA disbursements during the 2004-2005 award year; 55 randomly selected students for the 2003-2004 award year; and 40 randomly selected students for the 2002-2003 award year.

As we stated in Finding No. 1, except in the case of a late disbursement, a school may release the proceeds of any disbursement of a loan if the school determines the student has continuously maintained eligibility in accordance with the provisions of 34 C.F.R. § 682.201 from the beginning of the loan period for which the loan was intended. If, prior to the transmittal of the proceeds of a disbursement to the student, the student temporarily ceases to be enrolled on at least a half-time basis, the school may transmit the proceeds of that disbursement and any subsequent disbursement to the student if the school subsequently determines and documents in the student's file that the student has resumed enrollment on at least a half-time basis. (34 C.F.R. § 682.604(b)(2))

Of the 27 improper disbursements, 7 were for the payment period immediately following the payment period the student last attended, 12 were for the payment period following one full payment period of inactivity, 7 were for the payment period following two full payment periods of inactivity, and 1 was for the payment period following five full payment periods of inactivity. (See **Enclosure 1**.) The 27 disbursements totaled \$81,018 (\$80,343 FFEL and \$675 Pell). The disbursements were made for the Winter 2004 through Spring 2006 payment periods. The students' billing histories showed students' accounts were credited for the amounts of the disbursements, and the University's records indicated accounts receivable was credited and cash debited on the same dates as the disbursements and for the same amounts as the disbursements. After determining the students were not registered for classes for the payment period, the University returned the funds within 2 to 10 days of the dates of the disbursements. (See **Enclosure 1**.)

Based on the sample results (20 of 205 students), we estimate that about 10 percent⁴ of all the disbursements made during the 2002-2003 through 2004-2005 award years should not have been made because students were not registered for classes for the applicable payment period. The University earns interest on all funds deposited in its bank account. That interest (referred to as an allowance by the University's bank) is used to offset fees charged by the bank to the account. By receiving Title IV, HEA program funds to which students are not entitled, the University is earning interest on Title IV, HEA program funds prior to returning the funds to the Department and FFEL lenders.

During the 2004-2005 award year, the University received about \$140 million in Title IV, HEA program funds. Using our estimate of 10 percent to identify the portion of this amount that should not have been disbursed because students did not register for classes, the University had the use of about \$3.5 million in federal funds every quarter for 2 to 10 days (\$140 million times 10 percent equals \$14 million; \$14 million divided by 4 quarters equals \$3.5 million per quarter). The Department may have paid interest benefits and special allowance on the improperly disbursed FFEL Program funds, and the disbursements may have resulted in other unnecessary payments. For example, because the University did not cancel all future FFEL disbursements after the borrowers stopped attending, the borrowers might have been treated as if they had stayed in school, and the dates on which the borrowers entered repayment on their loans might have been delayed.

⁴ The estimated percentage is not based on a statistical projection and, therefore, our sample results might not be representative of the universe of disbursements.

The University disbursed Title IV, HEA program funds to students who were not enrolled in an eligible program at the time of the disbursement, in part, because it implemented a “continuous enrollment policy.” Under its continuous enrollment policy, the University considers a student to be enrolled once he or she begins attendance. The University considers the student to be enrolled until the student officially notifies the University that he or she is ceasing attendance, or the University drops the student because he or she ceased attending for at least three consecutive payment periods. The University schedules disbursements of Title IV, HEA program funds for each of the student’s four payment periods for the award year at the beginning of the student’s academic year. According to the University’s Director of Financial Aid, if a student stops attending, the remaining scheduled disbursements are not canceled because the student could return for a future payment period. The University does not cancel future loan disbursements because it would have to reinstate the loans if a student were to return.

Insufficient staffing of the University’s financial aid office may have also been a cause for its making disbursements to students who were not enrolled. In the 2002-2003 and 2003-2004 award years, the financial aid office employed six people. From the 2002-2003 to the 2004-2005 award year, Title IV, HEA program funding increased approximately 85 percent with the student population increasing almost 117 percent, but the University added only 1 employee to its financial aid office—a 17 percent increase in staff.

Recommendations

We recommend the Acting COO for FSA require the University to

- 2.1 Develop and implement policies and procedures to provide reasonable assurance that funds are not disbursed or delivered to students after they have ceased attending.
- 2.2 Periodically evaluate the size of its financial aid office staff and ensure that it has sufficient staff to administer its Title IV, HEA programs.

University Comments

The University disagreed with this finding, stating that it complied with applicable regulations and that the disparity between the OIG’s and the University’s position centers on the definition of “disbursed”.

The University’s accounting system requires that it associate Title IV funds with a particular student in order to run the eligibility check. A student’s anticipated Title IV disbursement amount is allocated to the student in order to perform the eligibility check, but the corresponding funds are not actually “disbursed” from the Capella’s Federal Funds account to the student. While it may appear on the student’s billing history that the student received Title IV funds, the “credit” is meant to only show that the funds were received so that the eligibility check can be run and does not indicate an actual transfer of funds.

The University claims that each of the 20 students identified in our finding was matriculated in the University and enrolled in an eligible program, but the University identified each of the 20 students as not having registered for a course in the identified quarter. Therefore, the students

did not receive Title IV disbursements for such period. For each of these students, the University electronically received Pell and FFEL funds into its federal funds account, but it determined that the students were not registered, even though such students were otherwise enrolled in an eligible program and had completed coursework during a previous academic quarter. The University asserts that it did not disburse the Pell and FFEL funds from its federal funds account to the students (i.e., the funds were not credited to any student's account), the students did not have access to the funds, and the funds never left the University's federal funds account. Any returns of funds were made in accordance with regulations and, therefore, caused no harm to either the federal government or FFEL lenders.

OIG Response

We did not change our finding or recommendations. The University's assertion that it did not disburse funds to students because students did not have access to the funds is without merit. Under 34 C.F.R. § 668.164(a)(1), a disbursement is made when the student's account is credited:

[A]n institution makes a disbursement of title IV, HEA program funds on the date that the institution credits a student's account at the institution or pays a student or parent directly with—

- (i) Funds received from the Secretary;
- (ii) Funds received from a lender under the FFEL Programs; or
- (iii) Institutional funds used in advance of receiving title IV, HEA program funds.

Neither the regulations nor other guidance issued by the Department qualify this date based on the student's access to the funds in his or her account.

Additionally, the University's assertion that it did not disburse funds to students because the funds never left the University's federal funds account is without merit. There cannot be a disbursement from the federal account to the operating account, because the University uses a single account for both its operating account and federal funds account. All federal funds are deposited into the operating/federal funds account and remain there until such time as the University chooses to move the funds.

The University received Pell and FFEL funds for students into its operating/federal funds account for subsequent disbursement to students, and the students' billing history reflected the credit of federal funds to their accounts. Though the University retained control of the federal funds prior to returning the funds to the Department or FFEL lenders for students later determined to be ineligible, the University disbursed the funds: it received the funds on behalf of students and credited the students' accounts for the amount of the funds received. The University debited cash and credited accounts receivable for the amount of federal funds received. University officials informed us the only time cash associated with federal funds moves is when it is drawn into the operating/federal funds account, when the student receives a stipend for living expenses, when funds are transferred to the investment account, or when the funds are returned to the lender. There is no movement of cash when crediting students' accounts.

If we were to accept the University's position that the credits of Title IV, HEA program funds shown in the student's billing history do not represent true disbursements of Title IV, HEA program funds, we would have to question the accuracy and reliability of the billing history as a record of the student's financial transactions. It would not be possible for the University, the Department, or anyone else to distinguish between a credit of Title IV, HEA program funds made to run the required student eligibility check and a credit of Title IV, HEA program funds used to pay for the student's costs of attendance.

The University maintains the students in question were enrolled in eligible programs, but also agrees that the students were not registered for classes for the quarter. Under the definition of "enrolled," in 34 C.F.R. § 668.2, students who are not registered for classes are not considered to be enrolled:

Enrolled: The status of a student who . . . [h]as completed the registration requirements (except for the payment of tuition and fees) at the institution that he or she is attending

FINDING NO. 3 – The University Did Not Always Maintain Documentation to Substantiate Loan Exit Counseling

The University could not provide support to show exit counseling was performed for all students who received FFEL Program funds and later withdrew from the University. We reviewed the academic and financial aid records for 50 students randomly selected from a universe of 13,182 who received FFEL Program funds during the 2004-2005 award year. Of those 50 students, 25 ceased at least half-time study at the University. The University could not provide support to show it conducted exit counseling for 2 of the 25 students. In addition, the University performed exit counseling 11 to 18 months after 3 other students stopped attending.

Pursuant to 34 C.F.R § 682.604(g)

(1) A school must ensure that exit counseling is conducted with each Stafford loan borrower either in person, by audiovisual presentation, or by interactive electronic means. In each case, the school must ensure that this counseling is conducted shortly before the student borrower ceases at least half-time study at the school. . . . If a student borrower withdraws from school without the school's prior knowledge or fails to complete an exit counseling session as required, the school must ensure that exit counseling is provided through either interactive electronic means or by mailing written counseling materials to the student borrower at the student borrower's last known address within 30 days after learning that the student borrower has withdrawn from school or failed to complete the exit counseling as required.

.

(4) The school must maintain documentation substantiating the school's compliance with this section for each student borrower.

Failure to provide exit counseling could increase the risk that students will default on their FFEL Program loans. Increased FFEL defaults result in additional costs to the Department for default claims presented by guaranty agencies.

The University's procedures for loan exit counseling were not adequate. The procedures in effect during our audit period did not indicate when exit counseling should be performed. Also, the University's current Financial Aid Management System (FAM) does not provide reasonable assurance that the University will maintain evidence of exit counseling. According to the Financial Aid Director, retrieving data from FAM can be cumbersome due to the lack of system integration within FAM. The dates entered into this system to reflect exit counseling performance are award year specific and do not roll forward based on status. The Financial Aid Director also informed us that the University will be utilizing PeopleSoft as its financial aid management tool starting in the 2007-2008 award year. The process of notifying students will be automated, and the new system should allow financial aid to more easily track performance of exit counseling.

Recommendation

We recommend the Acting COO for FSA require the University to

- 3.1 Implement its exit counseling policies and procedures to provide reasonable assurance that exit counseling will be performed in a timely manner and documented for all students receiving FFEL Program funds.

University Comments

The University acknowledges that the exit counseling was performed late in the three cited instances, but it was nonetheless performed. With respect to the two students for whom exit counseling cannot be documented, the University considers these instances to be isolated occurrences.

Starting with the 2007-2008 financial aid year, the University will use PeopleSoft as its financial aid management tool. This integrated system will allow Financial Aid to more easily track the performance of exit counseling and the process for notifying students will be automated.

OIG Response

We reviewed the University's planned work flow process, under which it would use PeopleSoft software to identify students who require exit counseling. If implemented, the new software should improve the University's ability to provide support for exit counseling. Once implemented, the University should test the new system to ensure that its student borrowers receive exit counseling in a timely manner and that the exit counseling is documented. We revised our recommendation for Finding No. 3 to ask for the implementation, rather than the development and implementation, of the revised procedures for exit counseling.

FINDING NO. 4 – The University Disbursed FFEL Program Funds to a Student Enrolled in an Unapproved Program

According to 34 C.F.R. § 668.32(a)(1)(i), a student is eligible to receive Title IV, HEA program funds if that student is “a regular student enrolled, or accepted for enrollment, in an eligible program at an eligible institution.” During the 2004-2005 award year, the University disbursed \$1,891.50 in FFEL Program funds to one student enrolled in an ineligible program.

We reviewed the Department’s Eligibility Certification Approval Report and identified certificate programs administered by the University that were not approved by the Department. We reviewed the academic and financial aid records for 22 students randomly selected from a universe of 180 who received Title IV, HEA program funds during the 2004-2005 award year while enrolled in an ineligible certificate program. Twenty-one of the 22 students were also enrolled in an eligible program during the same period they were enrolled in the ineligible program, thereby earning a Title IV, HEA disbursement for their enrollment in the eligible program. However, the University disbursed FFEL Program funds to one student enrolled only in an unapproved program.

Recommendations

We recommend the Acting COO for FSA require the University to

- 4.1 Return \$1,891.50 to the lender.
- 4.2 Determine if any of the remaining 158 students received Title IV, HEA program funds while enrolled in only an ineligible program, and return any improperly disbursed Title IV, HEA program funds to the Department and lenders, as appropriate.

University Comments

The University concurred with our finding and considered it an isolated occurrence. The response states that, as part of an effort to update the University’s Eligibility Certification Approval Report (the “ECAR”), the University deleted from the ECAR certain programs that are no longer offered by the University. The program in question, which had been an approved and eligible program, was one of the programs deleted.

OIG Response

We have not changed our finding or recommendations. The University can support its assertion that the disbursement was an isolated occurrence by determining if any of the remaining 158 students received Title IV, HEA program funds while enrolled in only an ineligible program. Such a determination, which would only require identifying the students in the ineligible program who received Title IV funds, should not be excessively burdensome.

OTHER MATTERS

Review of Financial Aid Histories

According to 34 C.F.R. § 668.19(a)

Before an institution may disburse title IV, HEA program funds to a student who previously attended another eligible institution, the institution must use information it obtains from the Secretary, through the National Student Loan Data System (NSLDS) or its successor system, to determine—

- (1) Whether the student is in default on any title IV, HEA program loan;
- (2) Whether the student owes an overpayment on any title IV, HEA program grant or Federal Perkins Loan

For the 2004-2005 award year, University officials informed us that the University used worksheets to document the reviews of information obtained through NSLDS. However, the University did not always maintain those worksheets in the students' financial aid files because its policies and procedures did not require the reviews to be documented before disbursing Title IV, HEA program funds to students. The University began retaining the worksheets for part of the 2004-2005 award year and all of the 2005-2006 award year. The University's policy now requires the worksheets to be documented in the students' financial aid files before Title IV, HEA program funds can be disbursed.

Notification That Bank Account Contains Federal Funds

Pursuant to 34 C.F.R. § 668.163(a)(2)

For each bank or investment account that includes title IV, HEA program funds, an institution must clearly identify that title IV, HEA program funds are maintained in that account by—

- (i) Including in the name of each account the phrase "Federal Funds"; or
- (ii)(A) Notifying the bank or investment company of the accounts that contain title IV, HEA program funds and retaining a record of that notice; and
- (B) Except for a public institution, filing with the appropriate State or municipal government entity a UCC-1 statement disclosing that the account contains Federal funds and maintaining a copy of that statement.

The University uses a single bank account, and that account is used to receive federal funds. Although the University notified the bank that the account contained Title IV, HEA program funds, the account title did not contain the word "Federal," and the University did not file a Uniform Commercial Code (UCC)-1 statement with the appropriate State or municipal government entity disclosing that its bank account contained federal funds. After we brought the matter to the attention of University officials, the University worked with its bank to revise the name on the account. The account now properly discloses that it contains federal funds.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our audit were to determine whether the University complied with the HEA and selected regulations governing (1) return of Title IV, HEA program funds; (2) FFEL and Pell disbursements; (3) institutional eligibility; (4) program eligibility; and (5) student eligibility.

Our initial audit period covered the period July 1, 2004, through June 30, 2005 (2004-2005 award year). Because we identified instances of non-compliance during the 2004-2005 award year, we expanded our audit for objectives (1) and (2) to include the periods July 1, 2002, through June 30, 2003 (2002-2003 award year), and July 1, 2003, through June 30, 2004 (2003-2004 award year).

To achieve our objectives, we performed the following procedures.

1. Reviewed selected provisions of the HEA, regulations,⁵ and FSA guidance applicable to the audit objectives.
2. Identified the amount of Title IV, HEA program funds the University received on behalf of its students during the 2002-2003, 2003-2004, and 2004-2005 award years.
3. Reviewed the University's web site, the Department's Distance Education Demonstration Program web page, various other web sites, and organizational charts for the University and Capella Education Company to gain an understanding of the University's history and organization.
4. Reviewed *Report on Compliance with Specified Requirements Applicable to the SFA Programs*, for the years ended December 31, 2002, 2003, and 2004, prepared by Virchow Krause & Company, LLP Minneapolis, Minnesota.
5. Obtained and reviewed evidence, including state authorization, institutional accreditation, and Department certification, supporting the University's institutional eligibility.
6. Obtained and reviewed evidence, including program participation agreements, program descriptions in catalogs and applications, and program approval by a recognized accrediting agency, supporting the eligibility of the University's programs.
7. Reviewed written policies and procedures and interviewed University officials to gain an understanding of the University's internal control structure, policies, procedures, and practices applicable to the administration of its Title IV, HEA programs.
8. Reviewed the records (academic and financial aid) for 50 randomly selected Pell recipients and 50 randomly selected FFEL recipients to determine if students met the general student eligibility and program-specific eligibility requirements for the 2004-2005 award year. We randomly selected 50 of 801 Pell recipients and 50 of 13,182 FFEL recipients as recorded in NSLDS.
9. Reviewed the records (academic and financial aid) for 205 randomly selected Title IV, HEA program funds recipients to determine if the University disbursed Title IV, HEA program funds only to students enrolled in eligible programs during the 2002-2003, 2003-2004, and 2004-2005 award years. We randomly selected 40 of 6,444 students who received Title IV,

⁵ Code of Federal Regulations, July 1, 2002, 2003, and 2004 editions.

HEA program funds during the 2002-2003 award year; 55 of 10,107 students who received Title IV, HEA Program funds during the 2003-2004 award year; 55 of 801 students who received Pell funds during the 2004-2005 award year; and 55 of 13,182 students who received FFEL Program funds during the 2004-2005 award year as recorded in NSLDS.

10. Reviewed the records (correspondence, student transcripts, and billing histories) for 25 of 159 randomly selected students that NSLDS showed as having leaves of absences during the 2004-2005 award year and 50 of 151 randomly selected students shown by the University's records as having leaves of absences during the 2004-2005 award year to determine if the University had adequate support for students with leaves of absences.
11. Reviewed the records (correspondence, return to Title IV calculations, billing histories, and Scholarnet⁶ records) for 100 randomly selected students⁷ to determine whether the University (a) identified all students for whom funds should have been returned to the Title IV, HEA programs; (b) correctly calculated the amount of funds that should have been returned to the Title IV, HEA programs; and (c) returned Title IV, HEA program funds in a timely manner.
12. Reviewed the records (return to Title IV calculations, billing histories, transcripts, and Course Room links for classroom activity) for (a) 166 students randomly selected from a list of 225 students the University's records showed as unofficially withdrawing from the University during the 2002-2003 award year; (b) 162 students randomly selected from a list of 221 students the University's records showed as unofficially withdrawing from the University during the 2003-2004 award year; and (c) all 319 students the University's records showed as unofficially withdrawing from the University during the 2004-2005 award year. We used stratified random sampling techniques to select our samples for the 2002-2003 and 2003-2004 award years.⁸
13. Reviewed additional student attendance information, provided by the University in response to the draft report, to determine whether it was sufficient to reduce the number of students we originally considered ineligible based on inadequate documentation of attendance.

We relied, in part, on data provided to us by University officials. We used the data for drawing our samples to test the University's compliance with the requirements for returning Title IV, HEA program funds. Specifically, we used the University's data for unofficial withdrawals and leaves of absence. The University uses several different computer systems to record enrollment, application, academic, and financial information for its students. To ensure the reliability of the data, we used information from the Department's NSLDS and Common Origination and Disbursement (COD) system to corroborate data such as student enrollment and Pell and FFEL financial information provided by the University. We also used hard copy documents provided by students to the University as a source for corroborating enrollment and financial information

⁶ Scholarnet is an online application and loan processing product that allows schools to exchange FFEL and private loan information with any lender. Scholarnet allows schools to receive guarantee responses and disbursement information electronically and import and export CommonLine data to and from any CommonLine-compliant financial aid management system. The University uses Scholarnet and provided us information retrieved from Scholarnet for verification that refunds were paid.

⁷ We randomly selected (1) 25 of 48 students shown in NSLDS as students, other than students who graduated within 30 days of the loan period begin date, who had stopped attending at least half-time; (2) 25 of 711 students shown in NSLDS as students who had stopped attending at least half-time and also had evidence of a loan cancellation; and (3) 50 of 39,274 students from a drop list provided by the University for the 2004-2005 award year. The drop list contained students who dropped individual classes as well as students who left the University. Therefore, students could appear on the list more than once during the award year.

⁸ Students could withdraw more than once within an award year, thereby increasing their chances of being selected for our samples.

provided by the University via its various computer systems. Based on these tests, we concluded the data the University provided us were sufficiently reliable for our purposes.

We performed our audit work at the University's office in Minneapolis, Minnesota, and our Chicago, Illinois, and Kansas City, Missouri, offices from April 2006 through January 2007. We discussed the results of our audit with University officials on January 10, 2007. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

Enclosure 1: Disbursements to Students Who Were Not Enrolled

| Student | Last Payment Period in Which Student Was in Attendance | Payment Period Disbursement Was Made | Number of Fully Inactive Payment Periods Since Last Attendance | Number of Days Funds Were Held** |
|--|--|--------------------------------------|--|----------------------------------|
| 1 | Fall 2004 | Spring 2005 | 1 | 9 |
| 2 | Fall 2004 | Spring 2005 | 1 | 3 |
| 3* | Summer 2005 | Winter 2006 | 1 | 3 |
| 3* | Summer 2005 | Spring 2006 | 2 | 5 |
| 4 | Fall 2004 | Spring 2005 | 1 | 8 |
| 5 | Fall 2004 | Spring 2005 | 1 | 9 |
| 6 | Winter 2006 | Spring 2006 | 0 | 10 |
| 7 | Summer 2005 | Spring 2006 | 2 | 5 |
| 8 | Summer 2005 | Spring 2006 | 2 | 7 |
| 9 | Fall 2005 | Spring 2006 | 1 | 5 |
| 10 | Summer 2004 | Spring 2005 | 2 | 7 |
| 11 | Spring 2005 | Fall 2005 | 1 | 4 |
| 12* | Fall 2005 | Winter 2006 | 0 | 3 |
| 12* | Fall 2005 | Spring 2006 | 1 | 9 |
| 13 | Fall 2005 | Winter 2006 | 0 | 8 |
| 14* | Summer 2004 | Winter 2005 | 1 | 5 |
| 14* | Summer 2004 | Spring 2005 | 2 | 3 |
| 15* | Summer 2005 | Winter 2006 | 1 | 8 |
| 15* | Summer 2005 | Spring 2006 | 2 | 5 |
| 16 | Winter 2004 | Spring 2004 | 0 | 8 |
| 17 | Winter 2006 | Spring 2006 | 0 | 5 |
| 18* | Fall 2004 | Winter 2005 | 0 | 2 |
| 18* | Fall 2004 | Spring 2005 | 1 | 5 |
| 19 | Summer 2002 | Winter 2004 | 5 | 3 |
| 20* | Summer 2004 | Fall 2004 | 0 | 5 |
| 20* | Summer 2004 | Winter 2005 | 1 | 3 |
| 20* | Summer 2004 | Spring 2005 | 2 | 5 |
| *Same student had more than one disbursement. | | | | |
| ** Number of days from the date of disbursement to the date the funds were returned. | | | | |

Enclosure 2: University Comments on the Draft Audit Report

CAPELLA EDUCATION
COMPANY

* *

September 25, 2007

Mr. Gary Whitman
Acting Regional Inspector General for Audit
US Department of Education, Office of Inspector General
Citigroup Center
500 West Madison Street, Suite 1414
Chicago, IL 60661

Re: Draft Audit Report Control Number ED-OIG/A05G0017

Dear Mr. Whitman:

Enclosed is Capella's response to the draft audit report forwarded by you to Dr. Michael Offorman of Capella by letter dated August 23, 2007. I would be remiss if I did not express our appreciation for the way in which your staff, and in particular Mr. Roedel, kept us informed about the progress of the audit and sought our input to better understand our policies and practices.

In the enclosure we have restated from your draft report each finding. We have then provided Capella's response to each finding.

If you have any questions about our response, please feel free to contact me electronically at greg.thorn@capella.edu, or by telephone at 612-877-6470.

Sincerely,



Gregory W. Thorn
Vice President, Governmental Affairs
General Counsel and Secretary

FINDING NO. 1 – The University Determined Incorrectly the Amounts to Be Returned to the Title IV, HEA Programs

Finding:

The University did not return all funds disbursed on behalf of students who dropped before their first day of class for the payment period. The University used the midpoint of the academic quarter (payment period) as the withdrawal date for all students who left school without providing official notification to the University (unofficially withdrew). The University used the midpoint even when it lacked documentation that the student engaged in academic activity during the payment period. By always using the midpoint of the payment period as the student's withdrawal date, the University retained approximately 50 percent of the Title IV, HEA program funds it received on behalf of students for whom it lacked documentation of academic activity, even though the University was required to return all Title IV, HEA program funds for those students.

Capella University Response:

Capella University ("Capella" or "the University") has implemented various procedures to monitor and identify unofficial withdrawals. The University has also established processes to secure notification that a student has unofficially withdrawn and to perform Return to Title IV calculations for such students.

The University's policies and procedures for unofficial withdrawals require all faculty members to indicate whether a student receiving a failing grade (i.e. "F") was given such a grade due to inadequate academic performance or failure to participate in the course. If the faculty member indicates that the student failed to participate, Capella determines that the student unofficially withdrew and performs a Return to Title IV calculation using the midpoint of the payment period pursuant to 34 C.F.R. 668.22(c)(1)(iii).

In April 2006, the University enhanced its procedures to better ensure student engagement prior to disbursing Title IV funds to students who are registered for the payment period. Under the enhanced procedures, Capella monitors course room activity at the beginning of each payment period, and incident to that monitoring, generates an engagement eligibility report for each Title IV-eligible student who registered for the payment period. This engagement check is done at the time federal funds are received into the Capella's Federal Funds account and prior to disbursing such funds to the student. If the eligibility engagement report shows that a registered student is not engaged (i.e. the student has not had any presence in the course room), the University notifies the student that his or her Title IV disbursement will not be applied to his or her account and the Title IV funds are returned to their appropriate sources. This engagement eligibility check is also part of the University's proactive outreach to its online students. Capella uses the report to gather information on students who, for one reason or another, are struggling with participation, and then provides appropriate academic support services.

For the Summer 2006 quarter, the first quarter for which the University fully implemented its enhanced procedures, the engagement eligibility report process was performed on approximately 9,000 students. The process identified only 75 students who were registered for courses and otherwise eligible for Title IV funds, but had not engaged in their courses. Of the 75 students

identified and provided notice by the University, 70 students subsequently engaged in their courses. The remaining 5 students withdrew from their courses and Capella returned the pertinent Title IV funds prior to disbursing such funds to the students. The University expects that it will continue to see very low levels of non-participation at the time Title IV funds are disbursed, and will continue to also verify engagement at the time grades are provided by faculty members.

Capella has reviewed the audit team work papers that support the findings contained in Table I on page 6 of the draft report. Based on that review, the University segments the cited instances of alleged noncompliance into three categories: (i) those instances for which we agree with the findings of the OIG; (ii) those instances for which we are providing additional data demonstrating that the University properly handled each cited instance; and (iii) those instances for which we respectfully submit that the OIG has applied an unsupported requirement of “engagement” where pertinent regulations require only “attendance” and, as a result, erroneously determined that the University incorrectly handled those instances.

Attached hereto as Attachment 1 are the audit team work papers supporting the findings contained in Table I. Capella has annotated the work papers by inserting as “1,” “2” or “3” following the last name of each student, and in certain instances, by describing course room activities of students for whom it is alleged that the University improperly retained Title IV financial aid amounts. In the cases of those students annotated with a “1,” the University agrees with the OIG’s finding that Title IV amounts were improperly retained. The University believes that the procedural changes described in the third and fourth paragraphs of the Response to this Finding No. 1 have prevented and will continue to prevent errors resulting in improper retention of Title IV funds, from and after the date of full implementation in the Summer 2006 quarter.

In the cases of those students annotated with a “2,” the University believes the course room activities of those students for the quarters in question were sufficient to demonstrate attendance, and even “engagement” as apparently defined by the draft audit report. As a result, Capella believes that it properly handled Title IV funds in those instances. It is the University’s understanding, based on prior communications with the OIG audit team, that due to time constraints surrounding the draft report, the audit team was not able to consider and reflect in its draft report all course room activity of all students listed in the work papers. It is Capella’s further understanding that the audit team intended to consider this additional information following receipt of the University’s response to the draft report. As such, for the students annotated with a “2,” the University has included on Attachment 1 comments as to the activities of each student in the course room. The University will provide to the OIG such additional documentation as may be requested to corroborate the University’s position with respect to these students.

In the cases of those students annotated with a “3,” the University respectfully disagrees with the OIG as to the appropriate regulatory standard for determining whether a full or partial return of Title IV funds is required. As noted by the OIG draft report, 34 C.F.R. § 668.21 provides, in pertinent part, that “[i]f a student officially withdraws, drops out, or is expelled before his or her first day of class of a payment period, all funds paid to the student for that payment period. . . are an overpayment.” And “[f]or purposes of this section, the Secretary considers that a student drops out before his or her first day of class of a payment period if the institution is unable to document the student’s attendance at any class during the payment period” (emphasis added).

Additionally, 34 C.F.R. § 682.604(d)(4) provides, in pertinent part, that “[i]f the school is unable for any other reason to document that a registered student attended school during the enrollment period for which the loan is made, the school must . . . return to the lender – (i) Any loan proceeds credited directly by the school to the student’s account . . .” (emphasis added).

With respect to the group of students annotated with a “3,” the University asserts that it has correctly applied the pertinent regulatory requirements based on student attendance. For each of these students, the University is able to document the student’s attendance in the course room, generally in the early part of the quarter in question. Such documentation was provided to the audit team. The OIG report, however, rejects the attendance documentation for these students and instead subjects the University to a heightened standard of “academic engagement,” which we believe has no basis in pertinent statute or regulation.

In the context of a “traditional” institution with a physical campus (a so-called “bricks and mortar” institution), attendance is readily discernable from a student’s physical presence in a classroom. Under both 34 C.F.R. § 668.21 and 34 C.F.R. § 682.604(d)(4), as cited in the draft report, to satisfy the “attendance requirement,” a bricks and mortar institution would thus only have to demonstrate that a student was present in the classroom.

As the draft audit report correctly states, Capella is an entirely online institution and therefore does not maintain physical classrooms. Students attend classes by posting information to virtual course rooms and participating in online class dialogue with faculty and fellow students. Demonstrating attendance in this context, however, is not significantly different from a bricks and mortar setting. When a student posts his or her profile to the course room, poses questions to a faculty member, or agrees to a faculty expectation sheet, the student has attended the class every bit as much as – if not more than – a student who signs into the first day of class at a bricks and mortar institution and otherwise sits silently through one or more lectures. The draft audit report, however, rejects Capella’s documentation of attendance and imposes a heightened standard of “academic engagement.”

The University’s concerns with this heightened standard are several. First, as noted above, the pertinent regulations reference only “attendance” and Capella has provided probative evidence that students began attending their courses. To require additional evidence of “academic engagement” changes the standard set forth in both 34 C.F.R. § 668.21 and 34 C.F.R. § 682.604(d)(4). We are aware of no statutory or regulatory basis for this standard, regardless of whether an institution conducts its courses online or in a bricks and mortar classroom. Moreover, the University has conformed its financial aid administrative practices to existing regulatory requirements. The retroactive application of a previously unannounced standard, through a compliance audit, is fundamentally unfair to institutions under audit, such as Capella in this case. If there are to be additional, heightened standards imposed upon institutions, we believe that such new requirements must be promulgated through proper administrative rulemaking procedures, including appropriate notice and comment.

Second, from a public policy standpoint, the decision as to what constitutes “academic engagement” can be a highly subjective analysis, thus complicating the coherent and consistent administration of the Title IV programs. While Capella does not concede that anything more than attendance is required under the regulations at issue, we would also assert that many of the students annotated with a “3” were in fact “academically engaged,” for example, by asking

questions about the homework process and otherwise engaging with professors and fellow students. The OIG rejects such activities as insufficient to demonstrate engagement, under what we believe amounts to be an unwritten and ambiguous standard. Perhaps because of these very concerns about subjectivity, the applicable regulations set forth the more objective and understandable standard of “attendance,” which the University in turn believes it satisfied with respect to students annotated with a “3.”

Notably, certain other Department regulations that are unrelated to this Finding No. 1 reference a form of “academic engagement” standard that is not present in either 34 C.F.R. § 668.21 or 34 C.F.R. § 682.604(d)(4). Under the separate requirements of 34 C.F.R. § 668.22(c)(3), for example, an institution that is not required to take attendance (such as Capella) may, at its option, determine a previously enrolled student’s withdrawal date was the student’s last date of documented attendance at an “academically related activity.” The fact that the Department did not incorporate a similar “academically related activity” concept into the language of 34 C.F.R. § 668.21 or 34 C.F.R. § 682.604(d)(4), but instead promulgated a standard of “attendance,” is further evidence in our opinion that the OIG audit report seeks to impose upon Capella a requirement that is not supported by existing regulations.

To conclude, prior to commencement of this OIG audit, the University was preparing to implement the procedural modifications described in the third and fourth paragraphs of its Response to this Finding No. 1, and in fact did implement those modifications beginning in April 2006. Based on subsequent testing done by the University, including the testing described in the fourth paragraph of the Response to this Finding No. 1, the University believes that errors made in prior aid years will not reoccur.

FINDING NO. 2 – The University Disbursed Title IV, HEA Program Funds to Students Who Were Not Enrolled

Finding:

The University disbursed Title IV, HEA program funds (FFEL and Pell) to students who were not enrolled in an eligible program at the time of the disbursement. We reviewed the records for 205 randomly selected students for whom the University made Title IV, HEA program disbursements during the 2002-2003, 2003-2004, and 2004-2005 award years. The University made 27 disbursements of Title IV, HEA program funds to 20 of the 205 students even though the students stopped attending during a previous payment period, were not enrolled in any classes for the applicable payment period, and were not charged tuition for the payment period for which funds were disbursed.

Capella University Response:

The University respectfully disagrees with this finding and believes that it complied with applicable Department of Education regulations. The disparity between the OIG's apparent position on this Finding No. 2 and the University's belief that it is in compliance seems to turn on the definition of "disbursed."

Contrary to the audit report's assertions, Capella did not "disburse" Title IV, HEA funds to students identified by this Finding No. 2. Each of the 20 pertinent students was matriculated in the University and enrolled in an eligible program, but was further identified by Capella as not having registered for a course in the identified quarter and therefore received no Title IV disbursements for such period. For each of these continuing students, the University electronically received Pell and FFEL funds into its Federal Funds account for subsequent disbursement to the student's account. When Capella determined that the students were not registered for the pertinent academic quarter, even though such students were otherwise enrolled in an eligible program and had completed coursework during a previous academic quarter, the University did not disburse the Pell and FFEL funds from its Federal Funds account to the students (i.e., the funds were not applied to any student's account).

The University's accounting system requires that it associate Title IV funds with a particular student in order to run the eligibility check. A student's anticipated Title IV disbursement amount is allocated to the student in order to perform the eligibility check, but the corresponding funds are not actually "disbursed" from the Capella's Federal Funds account to the student. While it may appear on the student's billing history that the student received Title IV funds, the "credit" is meant to only show that the funds were received so that the eligibility check can be run and does not indicate an actual transfer of funds. If the student is determined to be ineligible, the funds are returned from the Federal Funds account to either the Department or the applicable lender, as required under 34 C.F.R. § 668.167(b). None of the pertinent students gained access to Title IV funds in connection with this process.

Capella constantly monitors its compliance with 34 C.F.R. §§ 668.32(a)(1)(i) and 668.32(a)(2), and performs monthly internal audits regarding its timely return of FFEL funds to lenders for matriculated students who fail to attend a particular academic quarter. The University also utilizes a pre-disbursement eligibility report (Attachment 2 to this Response) in an attempt to

limit the amount of Title IV funds that are received into its Federal Funds account which may have to be returned, although any such returns that are necessary are made in accordance with all applicable regulations and therefore cause no harm to either the federal government or FFEL lenders. The pre-disbursement eligibility report takes into account the University's most current registration data for a pending academic term, along with other Title IV eligibility criteria (e.g., academic progress, enrollment status), and compares such data against the pending disbursement roster provided by Great Lakes Higher Education Corporation, the University's designated guaranty agency. The intent of this proactive procedure is to prevent, as much as possible, FFEL lenders from delivering Title IV funds via electronic transfer into the University's Federal Funds account for continuing matriculated students who have not registered for the pending quarter or have otherwise become ineligible. However, as previously stated, any Title IV funds delivered by the lenders which cannot be subsequently disbursed to students are returned in full compliance with 34 C.F.R. § 668.167(b).

**FINDING NO. 3 – The University Did Not Always Maintain Documentation to
Substantiate Loan Exit Counseling**

Finding:

The University could not provide support to show exit counseling was performed for all students who received FFEL program funds and later withdrew from the University. We reviewed the academic and financial records for 50 students randomly selected from a universe of 13,182 who received FFEL program funds during the 2004-2005 award year. Of those 50 students, 25 ceased as least half-time study at the University. The University could not provide support to show it conducted exit counseling for 2 of the 25 students. In addition, the University performed exit counseling 11 to 18 months after 3 other students stopped attending.

Capella University Response:

The University does conduct exit counseling for students who receive FFEL funds and who later withdraw from school. The University currently tracks three types of students who are required to receive exit counseling information: (1) students who withdraw both officially and unofficially, (2) students who drop to less than half-time enrollment and are reported to the Department via the National Student Clearinghouse, and (3) students who are disenrolled for cause. The University acknowledges that the exit counseling was performed late in the three cited instances, but it was nonetheless performed. With respect to the two students for whom exit counseling cannot be documented, the University considers these instances to be isolated occurrences.

Because of the lack of system integration within the University's current Financial Aid Management System, the dates entered into the system to reflect exit counseling performance are award-year specific and do not roll forward based on status or may be captured in another system. The University readily acknowledges that retrieving this data from the current Financial Aid Management System can be cumbersome and may have proven to be difficult during the audit process. However, starting with the 2007-08 financial aid year, the University will be utilizing PeopleSoft as its financial aid management tool. This integrated system will allow Financial Aid to more easily track the performance of exit counseling for all three of the student populations identified above, and the process of notifying these various populations will be automated. Included with this Response at Attachment 3 are workflow diagrams outlining the procedures under the new PeopleSoft financial aid management system.

FINDING NO. 4 – The University Disbursed FFEL Program Funds to a Student Enrolled in an Unapproved Program

Finding:

According to 34 C.F.R. § 668.32(a)(1)(i), a student is eligible to receive Title IV, HEA program funds if that student is “a regular student enrolled, or accepted for enrollment, in an eligible program at an eligible institution.” During the 2004-2005 award year, the University disbursed \$1,891.50 in FFEL program funds to one student enrolled in an ineligible program.

Capella University Response:

The University agrees with this Finding. As part of an effort to update the University’s Eligibility Certification Approval Report (the “ECAR”), the University deleted from the ECAR certain courses no longer offered by the University. The course in question, which had been an approved and eligible course, was one of the courses deleted. Unfortunately, after the University announced that the course was being discontinued, several students requested permission to take the course, citing hardships if not allowed to complete the course. The University granted those requests, and one of the students who took the class did so by utilizing FFEL program funds.

The University believes this mistake was an isolated occurrence, caused primarily by the University’s desire to continuously maintain an accurate ECAR and to provide timely updates toward that end.